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IN THE

Supreme Court of the United States

No. 287

October Term, 1946.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

HENRY S. DRINKER,
1429 Walnut Street,
Philadelphia 2, Pa.,
For Petitioner.

International, 20 Chestnut St., Phila. 6, Pa.

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1946.

No.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, J. Robert Bazley, prays that a writ of certiorari issue to the United States Circuit Court of Appeals for the Third Circuit, which affirmed the decision of the Tax Court sustaining the respondent in holding petitioner liable for additional Federal income tax for 1939, in the sum of $214,170.52, by reason of his exchange, pursuant to a Plan of Reorganization, of his 798 $100 par shares of the common stock of J. Robert Bazley, Inc., held by him since 1930, for 3,990 no par shares and $319,200 principal amount of 20 year 6% debenture bonds of said corporation.

Statement of the Matter Involved.

In 1939 petitioner's company, of which he and his wife owned practically all the outstanding stock (1,000 $100 par shares) was engaged in the contracting business, principally in "stripping" the earth and rock overlying veins of an-

thracite coal. This business being then very poor, petitioner's Company considered going into the hazardous business of road building. The Company having accumulated a surplus of $855,783.82, most of which had been ploughed back into plant and equipment, it was deemed advisable to rearrange the company's capital structure so that less would be represented by the stock, both in order to leave less at the risk of the business and in order to reduce the unit value of the shares. Accordingly, a recapitalization was duly effected under Pennsylvania law, the outstanding 1,000 shares of $100 par stock being exchanged for 5,000 no par shares and $400,000 principal amount of 20 year 6% debenture bonds.

The Tax Court found four "reasons for adopting the transaction" (R. pp. 91a-92a):—

1. The stockholders, in receiving in exchange for the outstanding 1,000 shares, debentures as well as no par stock, would have, in part, a more marketable security, which would be particularly advantageous where necessary to liquidate a part of a deceased stockholder's investment in order to meet inheritance taxes and other expenses.

2. The debentures could be sold by the stockholder where necessary without reducing the stock control in the management of the company.

3. The debentures would constitute a preferred obligation which, in case of eventual reverses incident to the hazardous road building in which the company was embarking, would share with creditors.

4. By reason of the fact that a large part of the company's earnings had been reinvested in fixed assets, it was deemed proper that the part of the earned surplus represented by the increased stated value of the common stock and by the par value of the bonds should be transferred from earned surplus to capital, and no longer be available for dividends.

The Tax Court refused to credit petitioner's testimony that an additional reason was that petitioner and his associates deemed it desirable, by reducing the unit value of the stock, to make it feasible to sell some of it to the key employees and so give them a stake in the business,—because this had not in fact been done up to the time of the hearing. Petitioner, while pointing out that the company's capital structure had in fact been altered so as to make such a future sale feasible, does not, for the purpose of this appeal, dispute the Tax Court's finding.

The Tax Court held that the four reasons which it found had motivated the recapitalization were all reasons which benefited the *stockholders* as distinguished from the corporation. Construing this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465, a majority of the Tax Court held, (applying such construction for the first time in this case) that, although this was a transaction within the terms of section 112 (b) (3) [1] of the Act, and although the debentures were admittedly "securities" thereunder, nevertheless, in order for a recapitalization or other reorganization to come within such provisions it must have been undertaken for and result in a benefit to the *corporation* as distinguished from one to the *stockholders*. The majority of the Tax Court also refused to recognize any benefit to the corporation in the alteration of its capital structure in the manner which the stockholders desired, or in the saving of taxes by deducting the $24,000 annual interest charge on the debentures.

Five of the sixteen Judges of the Tax Court dissented.

The Circuit Court, Judges Maris and Goodrich dissenting, upheld the position of the majority of the Tax Court.

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(1) 112 (b) (3) "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

112 (g) "As used in this section . . . (1) The term 'reorganization' means . . . (E) a recapitalization."

The second point in the case was, assuming that the transaction did not constitute a tax-free reorganization because lacking a "corporate business purpose," nevertheless, since under the express allegations and admissions of the Commissioner and the express findings of the Tax Court it constituted a *single unitary transaction*,—the receipt of the new stock *and* debentures in exchange for the old stock, which had been held for 9 years,—any resulting gain was taxable as a *capital gain* under Section 117.

On this second point the Tax Court attempted no logical reconciliation of its *finding of fact* [2] that the transaction was a unitary exchange of old stock for new stock *and* debentures, with its *conclusion* that the distribution of the debentures was a taxable dividend. The Circuit Court in its original opinion (R. pp. 106-116), attempted to sustain the Tax Court's conclusion by revising the Tax Court's express finding that the transaction was a single exchange of old stock for new stock and bonds, so as to divide the transaction into two distinct steps,—an exchange of the old stock for new stock "followed by a distribution of the 20-year debenture bonds." The Court's attention having been called, on the reargument, to the Commissioner's express allegations and admissions that this was a single exchange and the Tax Court's finding to the same effect, the majority, in its revised opinion, ignored the Tax Court's finding to the effect that the exchange was a single transaction, and omitted the reference which it had made at the end of the first opinion to this Court's statement in the *Dobson* case [3] that "whether an apparently integrated transaction shall be broken up into several separate steps" is a question of fact on which the Tax Court's finding is controlling.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of

(2) See *infra* Brief, pp. 19-22 hereof.
(3) *Dobson v. Commissioner*, 320 U. S. 489, 502.

February 13, 1925 (43 Stat. 938, U. S. C. Title 28, section 347) and Section 1141 (a) of the Internal Revenue Code.

The judgment of the United States Circuit Court of Appeals to be reviewed was entered on April 16th, 1946, (No. 8947 October Term, 1945).

Questions Presented.

1. Did the receipt by petitioner of debenture bonds (with new common stock) of J. Robert Bazley, Inc., pursuant to a Plan of Reorganization of that Corporation duly adopted, whereby the entire 1,000 shares of previously outstanding par stock (including petitioner's 798 shares) were exchanged for 5,000 new no par shares *and* $400,000 6% debenture bonds, give rise to a non-recognized gain, the taxation of which was postponed under Section 112 (b) (3) and 112 (g) of the Internal Revenue Code, or did it constitute a dividend taxable under Section 115 (g)?

2. Under *Gregory v. Helvering,* 293 U. S. 465, must it affirmatively appear, in order that such recapitalization come within Sections 112 (b) (3) and 112 (g), that it was adopted and carried out for the benefit of the *corporation* as distinguished from a benefit to *stockholders?*

3. Was the present Plan adopted and carried out pursuant to a "legitimate corporate business purpose"?

4. If the receipt of such debentures with such new common stock in the exchange for old common stock did *not* constitute such a recapitalization, was not the gain realized therefrom a gain from an exchange, taxable as capital gain under Sections 112 (b) (2), 112 (c) (1) and 117?

Reasons for Allowance of the Writ.

I. This case raises important questions of federal law which have not been, but should be, settled by this court.

By a novel construction of this Court's opinion in *Gregory v. Helvering,* 293 U. S. 465, applied for the first

time to a decision more than nine years thereafter, the Tax Court has read into Section 112 (b) (3) a requirement that in order to come thereunder, a recapitalization must be for a "corporate business purpose," constituting a benefit to the corporate entity as distinguished from a benefit to the shareholders. There is, as is pointed out in the following brief, no basis in this Court's opinion in the *Gregory* case or in any of this Court's later decisions, to support this doctrine, nor had it been applied by the Tax Court or by any other Court in any decision prior to that in the case at bar.

There could be, it is submitted, no case involving more clearly a question of law than one which turns on the Tax Court's construction of a prior decision by this Court.

The gloss which, nine years after the *Gregory* decision, the Tax Court has read into it, introduces an attempted distinction,—between the bona fide purposes of a corporation and those of its shareholders,—so vague and legally unsound as to inject serious and unjustified confusion into the administration of Section 112 (b) of the Revenue Act. In case of many proper recapitalizations, such as those mentioned at the end of the Circuit Court's dissenting opinion, it would be impossible to find a distinct corporate motive; in many others, both those already consummated and others in the future, it will be impossible to determine in advance whether such a motive will be recognized by the Commissioner and by the Courts.

II. The decision is in conflict with other decisions of the Circuit Courts and of the Tax Court and with the Treasury Regulations.

While, because the "corporate business purpose" test is a recent invention of the Tax Court, the precise question involved in the first point has not heretofore been directly discussed by any Court, several Federal decisions are irreconcilable with it, as are numerous decisions by the Tax Court, cited in the following brief.

Shortly after the first argument in the case at bar before Judges Biggs, McLaughlin and O'Connell, another case involving the identical question, *Adams v. Commissioner*,[4] was argued before Judges Maris, Goodrich and O'Connell of the same Court. Reargument was ordered with that in the case at bar prior to any decision thereon, but it would appear, from the dissents of Judges Maris and Goodrich in the case at bar, that a majority of that Court supported the position of the petitioner Adams and that if a formal decision had been reached there would have been two conflicting decisions in the same Circuit.

The decision sought to be reviewed is irreconcilable with that of the Ninth Circuit in *Commissioner v. Kolb*, 100 F. (2d) 920, where, on page 926, in answer to the contention that the transaction was a sham condemned by the *Gregory* case, the Court enumerates ten "business purposes" for the recapitalization there approved, several of which, including the issue of $2,000,000 bonds for stock, could have been of no benefit to the corporation as distinguished from the stockholders.

The identical question is pending in the Seventh Circuit in *Heady v. Commissioner*, to review the decision of the Tax Court in *Heady*,[5] in which petitioner's brief has been filed, but argument not yet heard.

The decision of the Court below is irreconcilable with Sec. 19.112 (g)-2 of the Treasury Regulations defining and affirming as a "recapitalization" a case where:

> "(3) a corporation issues preferred stock, previously authorized but unissued, for outstanding common stock."

in which obviously no independent corporate purpose or benefit could be deduced.

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(4) Unreported, Docket No. 9069, October Term, 1945, petition for certiorari filed.

(5) Tax Court Docket No. 5812, unreported, but see C. C. H. T. C. Service, Dec. 14702 (M).

III. The decision of the court below is in conflict with applicable decisions of this Court.

The Tax Court found, in accordance with the express allegations and admissions of the Commissioner, that the recapitalization was a single transaction consisting of an exchange of the 1,000 old shares of $100 par for 5,000 new no par shares and $400,000 debenture bonds. Despite this finding, the Tax Court concluded that the debentures constituted a dividend on the stock. In order to sustain the conclusion of the Tax Court, the Circuit Court, contrary to the finding of fact by the Tax Court, said that the debentures were distributed, not as a part of the exchange constituting the recapitalization, but "following" it.

Under the decision of this Court in *Dobson v. Commissioner*, 320 U. S. 489 and subsequent cases, it is not the function of the Circuit Courts to modify the primary findings of fact by the Tax Court in order to sustain its conclusions, any more than to reverse them.

Had the Circuit Court accepted the Tax Court's primary finding of fact, it necessarily follows that assuming this was not a tax free reorganization, any resulting gain from a receipt of the bonds should have been taxed as a capital gain under Section 117.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court directed to the United States Circuit Court of Appeals for the Third Circuit, sitting at Philadelphia, Pennsylvania, commanding that Court to certify and to send to this Court, on a day certain to be therein named, a full and complete transcript of the record and all proceedings had in this case numbered and entitled on its docket [redacted], to the end that this case may be reviewed and determined by this Court; that the said judgment of the United States Circuit Court of Appeals for the Third Circuit may be reversed by this Court; and that your petitioner

may have such other and further relief in the premises as may seem just and proper.

And your petitioner will ever pray, etc.

J. Robert Bazley,
Petitioner.

Henry S. Drinker,
1429 Walnut Street,
Philadelphia 2, Pa.,
Attorney for Petitioner.

BRIEF IN SUPPORT OF THE PETITION.

Opinions Below.

The opinion of The Tax Court of the United States in this proceeding was promulgated on February 28, 1945. It is reported at 4 T. C. 897, and is printed on pages 89a-104a of the Record.

The opinions of the United States Circuit Court of Appeals for the Third Circuit have not been officially reported at the time of filing of this brief. The opinion of the three judges on the original argument was rendered on January 8, 1946, and is printed on pages 106-116 of the Record. This opinion was withdrawn by the Court on April 8, 1946 (R. pp. 125-126). The opinion of the majority (O'Connell, McLaughlin and Biggs, JJ.) of the five judges who heard the reargument was rendered on April 16, 1946, and is printed on pages 126-136 of the Record; and the dissenting opinion of Judges Maris and Goodrich upon the reargument is printed at pages 137-140 of the Record.

Jurisdiction.

The grounds on which jurisdiction of this Court is invoked are set forth in the Petition at pages 4-5 thereof.

Statement of the Case.

The Statement of the Case appears in the Petition at pages 1 to 4, and in the interest of brevity is not repeated here.

Specification of Errors.

The Circuit Court of Appeals erred:

1. In holding that a recapitalization, planned and duly consummated for bona fide purposes other than tax avoid-

ance, was not within the provisions of Sections 112 (b) (3) and 112 (g) of the Revenue Act because not undertaken for the benefit of the corporation as distinguished from that of the stockholders.

2. In supporting the Tax Court in its construction of this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465 as so stating the law.

3. In ignoring the Tax Court's finding of fact that the recapitalization under review consisted of a unitary exchange of old stock for new stock *and* debenture bonds, and holding that it consisted of an initial exchange of old stock for new stock *followed by* a distribution of the debentures, which constituted a taxable dividend, whereas, assuming that this was not a tax free "reorganization" under Section 112, the gain resulting was a capital gain, taxable under Section 117.

Statutes Involved.

The pertinent provisions of the Internal Revenue Code and of the Treasury Department Regulations are set forth at the end of this Brief.

ARGUMENT.

It is believed that the principal matter in the present petition requiring elaboration is the statement that the application and extension of the *Gregory* decision to disallow recapitalizations, not shown to have been for the benefit of the corporation, as distinguished from a benefit to all its stockholders, is a recent invention by the Tax Court, not warranted by this Court's opinion in that case.

This brief will therefore be devoted primarily to a concise history of the application of the *Gregory* decision in the Tax Court and the Circuit Courts, followed by brief comments on the basic legal unsoundness of the Tax Court's conclusion and the unfortunate consequences of introducing so vague and unworkable a test into the administration of Section 112 of the Revenue Code.

Gregory v. Helvering.

Both the Tax Court and the majority of the Court below recognize that the exchange of all the outstanding stock of a corporation for new stock *and* bonds constitutes a recapitalization and thus a reorganization under Section 112 of the Internal Revenue Code. *Helvering v. Watts,* 296 U. S. 387.

Gregory v. Helvering, 293 U. S. 465, did not hold that, in order to qualify as tax free, a "recapitalization" must be undertaken for the benefit of the *corporation* as distinguished from its *stockholders.* What it held was that where a dummy corporation is formed and used for the sole purpose of avoiding an impending tax liability, and is dissolved as soon as that purpose has been accomplished, it having in the meantime served no legitimate business purpose, it may be disregarded, and the transaction viewed in its true light, since the term "reorganization" does not contemplate a sham transaction adopted for the sole purpose of tax avoidance by means of a dummy corporation having no business function.

This Court did not, as the Tax Court and the majority of the Court below would apparently have it appear, speak of a "corporate business purpose." The Court merely referred to the dummy corporation as "an operation having no business or corporate purpose."

The idea that the *Gregory* case condemns a "recapitalization" (not undertaken or effective for the sole purpose of avoiding taxes), unless this be demonstrably for the benefit of the corporation, is an invention of the Tax Court and unsupported by any other court except the majority of the Court below. The fact that the change in capitalization is adopted by the stockholders for *reasons other than tax avoidance* renders the *Gregory* case inapplicable.

In none of the later decisions by this Court has the *Gregory* decision been interpreted or extended as the Tax Court and the Court below would have it appear. In all of them the decision was understood merely as prescribing the disregarding of sham corporations formed and used for the sole purpose of tax avoidance. See, for example, *Helvering v. Minnesota Tea Co.*, 296 U. S. 378, 385; *Griffiths v. Commissioner*, 308 U. S. 355, 357-358.

The interpretation of the case by the Circuits is to the same effect.[1]

Origin of the "Corporate Business Purpose" Test.

During the years following *Gregory v. Helvering*, that decision was applied by the Tax Court solely to cases

(1) See
Electrical Securities Corp. v. Commissioner, 92 F. (2d) 593, 594-595 (C. C. A. 2d);
Commissioner v. Gilmore's Estate, 130 F. (2d) 791, 795-796 (C. C. A. 3rd);
Commissioner v. Smith, 136 F. (2d) 556, 559 (C. C. A. 2d);
National Investors Corp. v. Hoey, 144 F. (2d) 466, 468 (C. C. A. 2d);
Morgan Mfg. Co. v. Commissioner, 124 F. (2d) 602, 605 (C. C. A. 4th);
Lyon v. Commissioner, 127 F. (2d) 210, 213 (C. C. A. 6th);
Commissioner v. Capento Securities Corp., 140 F. (2d) 382, 385 (C. C. A. 1st);
Tyson v. Commissioner, 146 F. (2d) 50, 54 (C. C. A. 8th).

similar to that there involved,—where the sole owner of the stock of a corporation desired to secure for sale to a prospective purchaser a portion of the corporation's assets, and for the purpose of avoiding the surtax which would result from receiving such assets as a dividend, organized a "conduit" corporation through which the asset should be passed and the dummy corporation be dissolved or become moribund, the transaction having been motivated solely by a desire to avoid an impending tax, the *conduit corporation* conducting no real business, and the whole transaction constituting what the Tax Court terms a "sham", masquerading in the guise of a reorganization.[2]

Where the Board considered that the transaction was a genuine one and not a sham, it held in these early cases that the *Gregory* principle was inapplicable.[3]

In a number of cases the Board of Tax Appeals and the Tax Court sustained recapitalizations which were clearly for the sole benefit of the stockholders, as distinguished from the independent corporate benefit, the distinction, later invented, not being discussed.[4]

Other recapitalizations which were not claimed to have benefited the corporation as distinguished from the stockholders, have similarly been sustained by the Circuit Courts.[5]

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(2) See *Royal Marchen*, 32 B. T. A. 76; *Handbird Holding Corp.*, 32 Id. 238; *Von's Investment Co., Ltd.*, 33 Id. 30; *Flanders Investment Co.*, 33 Id. 483; *Thomas N. Perkins*, 33 Id. 606; *Robt. R. McCormick, Exec.*, 33 Id. 1046; *Harold B. Franklin*, 34 Id. 927; *Electrical Securities Corp.*, 34 Id. 988; *Arthur S. Kleeman*, 35 Id. 17; *Helen Sperry Lea*, 35 Id. 243; *Philip J. Cogan*, 36 Id. 639; *A. W. Mellon*, 36 Id. 977; *George D. Graham*, 37 Id. 623; *Estate of Walter C. Bailey*, 37 Id. 647; *W. & K. Holding Corp.*, 38 Id. 830; *Belle G. Loewenberg*, 39 Id. 844; *Sam Pickard*, 40 Id. 258; *Robert M. Morgan*, 41 Id. 379.

(3) *Claude Neon Lights, Inc.*, 35 B. T. A. 424; *General Motors Corp.*, 35 Id. 523; *James Lee Johnson*, 37 Id. 155.

(4) *L. & E. Stirn, Inc.*, 39 B. T. A. 143; *Chester A. Souther*, 39 Id. 197; *Elmer W. Hartzel*, 40 Id. 492; *Peck and Peck*, 42 Id. 651; *Jacob Fischer*, 46 Id. 999; *Clarence J. Schoo*, 47 Id. 459; *Edgar M. Docherty*, 47 Id. 462; *Annis Furs, Inc.*, 2 T. C. 1096.

(5) See

Commissioner v. Kolb, 100 F. (2d) 920, 926 (9th Circuit);
Skenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268 (2d Circuit);
Morainville v. Commissioner, 135 F. (2d) 201 (6th Circuit);
Knapp Monarch Co. v. Commissioner, 139 F. (2d) 863 (8th Circuit).

The supposed necessity for a *corporate* business purpose as distinguished from a *stockholders'* objective, unrelated to tax avoidance, is a recent invention by the Tax Court, having been first definitely suggested in a dictum by Judge Harron in the case of *Humko Co.*,[6] decided by her in December, 1943, almost nine years after the *Gregory* decision. This test was applied by the Tax Court for the first time in the case at bar and in the companion case of *Adams*, 4 T. C. 1186; 5 T. C. 351 (*supra*, p. 7), and also in *Heady, supra*, now on appeal in the Seventh Circuit.

The Basic Unsoundness of the Tax Court's Test.

It is a fundamental principle of corporation law that all activities within the scope of the corporate charter,—whatever the corporation may properly do for its corporate benefit, in the furtherance of its business,—are to be carried on by its board of directors. Stockholder action is required and appropriate only in connection with matters which concern the relation of the stockholders among themselves,—which modify the agreement among them incident to their formation of the corporation, with which matters the corporation itself is not directly concerned. Thus, the directors alone may properly authorize the making of contracts. Under the laws of no State, however, may the directors change the capitalization by authorizing stock not provided for in the charter, or by altering the rights of the stockholders inter sese. These matters are for the *stockholders* and are a part of *their* business, not a part of the corporation's ordinary business.

The reorganization provisions of the Revenue Act are not confined to matters within the scope of the corporation's business,—matters which may be regulated by the directors; see Sec. 112 (b) (3), 112 (g) (1). These provisions apply to the stockholders as well as to the corporation. Indeed, the provisions relative to recapitalization

(6) Docket 112235, 79, unreported, but see C. C. H. T. C. Service, Dec. 13,642 (M).

concern the stockholders primarily, if not exclusively. Neither the Tax Court nor respondent nor the majority of the Court below have suggested any reason why, as to recapitalizations, a "business purpose" test should apply only to the corporation and should not apply to the stockholders, whose action as such is necessary to bring it about. Nor have they explained how there can conceivably be a "corporate business purpose" in connection with something which may be no part of the corporation's business and which, through its board of directors, charged with regulating its business, it has no power to regulate.

The Tax Court Has Invented a Test so Vague as to be Practically Unworkable.

The disregard by the majority of the Tax Court and by the majority of the Court below of the fundamental principle above summarized would, if followed, introduce into the administration of Section 112 of the Revenue Act a test so vague and variable as to introduce lamentable uncertainty into the administration of the law. As the dissenting opinion of Judges Maris and Goodrich clearly demonstrates, what is for the benefit of the corporation, as distinct from that of the stockholders, and vice versa, is something on which no two lawyers, no two accountants or no two business men could agree. To inject such a test as that proposed by the Tax Court into the administration of the law would render the soundness of a recapitalization under Section 112 dependent principally on the whim of the revenue agent, the Commissioner, or the Judge who passed on the case. It would also throw doubt on a great number of completed recapitalizations about which no previous doubt existed. For example, there have been and will doubtless be innumerable instances of reorganizations of corporations a majority of the entire capital stock of which is owned by a holding company which, for reasons of its own, desires to have the securities of a subsidiary in a different form,—stock for stock, bonds for stock, preferred

of a different type, etc. There has never been any suggestion that these recapitalizations are not tax free, although it is inconceivable that there could be any purpose except that of the holding company whose wishes the subsidiary is bound to carry out.

In the great majority of cases involving recapitalizations, the changes in the capitalization of a corporation are in reality advantageous only to the stockholders. For example, is there a demonstrable corporate advantage in the exchange of $100,000. par value 4% preferred stock and $100,000. par value of common stock for $80,000. par value 5% preferred and 1250 shares of no par common? What corporate advantage is there in the substitution of preferred stock for common stock, or in the recapitalization noted at the end of the dissenting opinion, where common stockholders arranged for a reclassification of part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control? If the rule here established be followed, it will set up a test of the validity of scores of recapitalizations so vague as to be wholly unpredictable, resulting in conclusions based on no substantial differences, in cases, all of which result in no change of continuity in control and in no present realization of actual gain to the stockholders, but merely in a change in the form of the security. Such a radical departure from long existing practice and legal standards should, it is submitted, be effected only by a prospective amendment to the law by Congress, or, at least, by this Court's own construction of its decision in *Gregory v. Helvering*.

The Dissenting Opinion.

The dissenting opinion by Judges Maris and Goodrich contains so clear and concise an analysis of the legal principles which these two judges apply to the Tax Court's findings of fact, that we find it impossible to summarize or abstract it. Accordingly, we refer to it, as printed on pages

137-140 of the Record, for a clear exposition of the fallacy of the Tax Court's "corporate business purpose" theory.

Findings of the Tax Court as to Unitary Exchange of Old Stock for New Stock *and* Bonds.

The second major ground on which this Court is asked to review the decision below is that the Circuit Court, contrary to the rule in *Dobson v. Commissioner*, 320 U. S. 489, has changed and modified an essential primary finding of fact by the Tax Court in order to sustain its conclusion of tax liability.

Assuming, for the purpose of the present argument, that the recapitalization was not tax free because not demonstrably for the benefit of the corporation, either

(1) the transaction was a single transaction,—a unitary exchange of the 1,000 old $100 par shares for 5,000 new no par shares *and* $400,000 debenture bonds; or,

(2) it was an exchange of the old stock for the new stock, *followed by* a distribution of the bonds as a dividend.

If the former, since the old stock which was exchanged in part for the bonds had been held by petitioner for 9 years, any gain realized from the exchange was taxable as a capital gain under Section 117.

The Tax Court found expressly that the transaction in question was an **exchange** of the old common stock for the new common stock **and** the debenture bonds.[7] In describing the plan of reorganization, it said:

> "The corporation was to issue **in exchange for the old stock**, the new stock **and** the debenture bonds . . ." (R. pp. 92a-93a.)

(7) In *Flanagan v. Helvering*, 116 F. (2d) 937, cited by the Circuit Court, there was admittedly a redemption of part of the corporation's stock, which the Tax Court held not to have been a partial liquidation but essentially equivalent to the distribution of a taxable dividend taxable as such under Sec. 115 (g).

In the case at bar, however, the Tax Court did not find, as it did in *Edith B. Bass*, 45 B. T. A. 1117, 1120-21 (see also 129 F. (2d) 300), that the transaction was an independent distribution not part of a unitary exchange.

> "**Pursuant to the plan**, the stockholders on March 16, 1939, delivered their 1,000 shares of common stock to the corporation and received from the corporation the 5,000 shares of its new common stock and debenture bonds in the aggregate principal amount of $400,000." (R. 93a-94a.) (Emphasis supplied.)

At the end of the first paragraph of its opinion the Tax Court again characterizes the transaction as "**an exchange of stock for stock and securities** of the same corporation" (R. p. 96a.)

The Tax Court also found the facts in the stipulation (R. 90a), paragraphs 10, 12 and 18 of which (R. 16a-18a) stated that the shares of new common stock and the debenture bonds were issued by the company **in exchange** for the shares of $100 par stock previously outstanding.

Under the record admissions and allegations by the Commissioner in this case, the Tax Court could not have found otherwise.

In his income tax return for 1939 petitioner had returned no gain from the receipt of the new stock and bonds in the recapitalization, taking the position that, under Section 112 (b) (3) and 112 (g) of the Act, no gain or loss was properly recognizable therefrom.

The Commissioner, however, increased petitioner's taxable income by $319,200, explaining such increase in the deficiency notice (R. 17a) as follows:

> "'(a) Other income has been increased $319,200 representing the fair market value of bonds of J. Robert Bazley, Inc., **received in exchange of common stock of that corporation.**'" (Emphasis supplied.)

In his petition to the Tax Court contesting the additional assessment based on the above, petitioner alleged, under paragraph V-(5) and (6) (R. pp. 5a-6a):

> "(5) **Pursuant to the Plan** of Reorganization and Recapitalization, **the corporation exchanged** the 5000 shares of new common stock without par value **and**

$400,000. of principal amount of debenture bonds for the 1000 shares of common stock outstanding. The exchange was made on the basis of 5 shares of new common stock without par value and $400. of debenture bonds for each share of old common stock outstanding. The 1000 shares of old common stock were then cancelled on the books of the corporation.

"(6) The Petitioner in April, 1939, pursuant to and in accordance with the terms of the Plan of Reorganization and Recapitalization received in exchange for his 798 shares of $100. par value common stock of J. Robert Bazley, Inc., 3990 shares of no par value common stock and $319,200. principal amount of 20 year 6% debenture bonds of the same corporation. . . .

. . . . . .

"In the further alternative, if it be held that Petitioner realized taxable income or gain in 1939 as a result of the foregoing exchange, then Petitioner contends that the Commissioner erred in determining that such income or gain was ordinary income instead of capital gain as provided by Section 117 of the Internal Revenue Code." (Emphasis supplied.)

In the Commissioner's answer to the above paragraphs of the petition, he alleged:

"(5) Admits that said corporation exchanged 5,000 shares of new common stock without par value and $400,000.00 of principal amount of debenture bonds for the 1,000 shares of old common stock outstanding; admits that the exchange was made on the basis of 5 shares of new common stock without par value and $400.00 of debenture bonds for each share of old common stock; admits that the 1,000 shares of old common stock were then cancelled; denies the remaining allegations of paragraph V (5) of the petition.

"(6) Admits that in April, 1939, petitioner received in exchange for his 798 shares of $100.00 par

value old common stock of J. Robert Bazley, Inc., 3,990 shares of no par new common stock of said corporation and $319,200.00 principal amount of 20-year 6% debenture bonds of said corporation; denies the remaining allegations of the first sentence of paragraph V (6) of the petition; * * * denies the remaining allegations and opposes the remaining contentions made by petitioner in said paragraph V (6) of the petition." (R. pp. 12a-13a.) (Emphasis supplied.)

In this Court's opinion in *Dobson v. Commissioner*, 320 U. S. 489, at page 502, the Court said:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact."

In disregard of the above ruling by this Court, in spite of the express admissions by the Commissioner on which were based express findings of the Tax Court above quoted, the majority of the Court below, as clearly shown by the last paragraph of its original opinion (R. p. 116), treated the transaction as one involving an exchange of the old stock for the new stock "followed by a distribution of the 20 year debenture bonds."

Under the rule of *Dobson v. Commissioner*, it is not the function of the Circuit Courts to alter the primary findings of fact by the Tax Court in order to sustain its legal conclusions, any more than to reverse them.

Respectfully submitted,

HENRY S. DRINKER,
For Petitioner.

ADDENDUM.

PERTINENT PROVISIONS OF THE CODE AND REGULATIONS.

(Emphasis in the text supplied throughout.)

CODE SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) **General rule.**—Upon the sale or exchange of property the **entire** amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

SEC. 112 (b). EXCHANGES SOLELY IN KIND.

(2) Stock for Stock of Same Corporation.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

SEC. 112 (b) (3). Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

SEC. 112 (g). DEFINITION OF REORGANIZATION.—As used in this section and section 113—

(1) the term "reorganization" means * * * (E) a recapitalization, * * *.

REGULATIONS 103, SEC. 19.112 (g)-2. **Definition of terms.**—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1): * * *

A "recapitalization," and therefore a reorganization, takes place if, for example—

* * * * * *

(3) **A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or**

* * * * * *

SEC. 112 (c). GAIN FROM EXCHANGES NOT SOLELY IN KIND.

(1) If an exchange would be within the provisions of subsection (b) * * * (2) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, **to the recipient shall be recognized**, but **in an amount not in excess** of the sum of such money and the **fair market value of such other property.**

(2) If a distribution made in **pursuance of a plan of reorganization** is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) Definition of dividend.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2)

out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(c) Distributions in liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. * * *

(g) Redemption of stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

SEC. 117. CAPITAL GAINS AND LOSSES.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months..